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6 AUG 1985

MEMORANDUM FOR: See Distribution

FROM:

Chief, Economics Division
Office of Global Issues

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SUBJECT: Lessons Learned from the Pre-World War II Debt Crises

Attached is a report which I think you will find of interest. It describes the debt default situations in which the United States was involved prior to World War II. We have included a final section which outlines what we think are the lessons learned from how these situations were handled. If you have any questions or need further assistance feel free to call me

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Attachment:
As Stated

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Central Intelligence Agency



Washington, D. C. 20505

DIRECTORATE OF INTELLIGENCE

6 August 1985

Pre-World War II Debt Crises: Some Lessons Learned**Summary**

After emerging as a major international creditor during the First World War, the United States became entangled in three loan repayment problems. The US government negotiated settlements during the 1920s with its Allies for wartime debt and with Germany for repayment of war damages. Private US lenders also readjusted debt for several Latin American countries after defaults were brought on by the Great Depression. [redacted]

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The settlements used various techniques to provide debt relief and to set the stage for debt servicing. Several of these techniques--including loan refunding and maturity extension--are found in current debt restructuring arrangements. Other techniques were unique, such as drastic reduction in interest rates, write-off of principal, and widespread repurchase of defaulted debt by borrowers. [redacted]

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This memorandum was prepared at the request of Richard McCormack, Ambassador to the OAS by [redacted] Financial Issues Branch, Office of Global Issues. Comments may be directed to Chief, Economics Division, [redacted]

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Although the settlement of interwar defaults resembles current approaches to debt relief, crucial differences in the nature of the underlying debt allow only broad insights on contemporary debt restructuring exercises. Debt readjustment strategies ultimately succeeded only when debtors were able to export enough to finance debt repayments. The significant debt relief provided for the Allies and Germany failed to prevent default when exports collapsed during the Great Depression. Latin America, however, successfully serviced its readjusted debt after the Depression because the Second World War generated strong demand from the United States and other creditors for the region's exports.

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Debt, Depression and Default

The United States first emerged as a major international creditor during the First World War and during the interwar period became entangled in several loan repayment problems. These problems involved two classes of international obligations: wartime debts and postwar private loans.

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The war debts comprised two distinct groups. One group represented official US short-term credits to Allied governments, issued to finance war material sales and postwar relief and reconstruction, which amounted to over \$10 billion. The other group involved about \$33 billion of reparations payments charged against Germany for war damages owed to the United States and other Allied governments.

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Private long-term lending abroad after the war generally took the form of investment in foreign bonds; medium- and long-term international bank lending was negligible before the Second World War. Most foreign bonds were long-term, fixed-interest instruments issued by foreign governments and sold to US businesses and individuals through New York investment banks. About 80 percent of the increase in US investments in Latin America during 1919-1930 took the form of bonded debt. All told, foreigners issued \$10.5 billion of bonds in the New York market from 1920 to 1931, a figure larger than the total of foreign

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overnment bonds floated in London -- the leading world financial center -- during the previous half century. These foreign bonds were widely issued and were traded on an active secondary market. [REDACTED]

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The explosion of US foreign lending during the 1920s largely reflected economic conditions in the United States. Relatively low domestic interest rates--the product of easy US monetary policies--encouraged investment in higher yielding foreign bonds.¹ The inherent riskiness of foreign bond purchases was discounted by US investors, who were caught up in the domestic economic boom, the intense banker competition for lucrative commissions on foreign bond sales, and the widespread perception that Europe and Latin America afforded profitable investments.

[REDACTED]

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Foreign borrowers eagerly sought US credit. Europeans raised funds to reconstruct war-torn economies, to stabilize exchange rates, and to finance growth and world trade after the mid-1920s. Latin American credit demand intensified with the increase in primary commodity prices and industrial growth. [REDACTED]

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Serious repayment problems emerged after 1929 with the onset of the Great Depression. Severe US economic problems quickly spread to Europe and Latin America through the international system of fixed exchange rates. Foreign trade declined under the

¹ The average yield (at prices offered to the public) of new Latin American dollar bonds issued between 1921 and 1928 remained consistently 40 percent above the yield on high-grade US domestic bonds. [REDACTED]

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weight of increased protectionism and the fall in US demand for imports. International liquidity fell as the main creditor countries--led by the United States--cut net foreign lending by 84 percent from 1928 to 1930.

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These macroeconomic shocks strained the willingness of Germany and Latin America to service foreign debts. The decline in export prices greatly increased the real cost of servicing the massive amount of fixed high interest rate bonds issued during the 1920s. Germany and Latin America initially serviced their debts by liquidating holdings of international reserves, requiring them to deflate their economies as long as they maintained fixed exchange rates. After 1930, debtors increasingly chose to depreciate their currencies to limit their economic contraction, but the severe deterioration of business conditions eventually encouraged debtors to default--i.e., to fail to pay contracted interest or amortization. Almost all defaults took place by 1934.

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President Hoover temporarily suspended the servicing of Allied war debts and German reparation payments in 1931 in view of the deteriorating world economy, but debtors subsequently failed to resume repayment. The value of delinquent principal owed by the Allies in 1931 exceeded \$9 billion. Interest payments on about 40 percent of outstanding foreign dollar bonds held in the United States were also in default in 1935, involving nearly \$2.5 billion of the \$6 billion of outstanding bonds. The proportion of dollar bond defaults was highest in Latin America (70 percent) and Europe (51 percent).

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A second wave of defaults on interwar foreign government bonds occurred during World War II. By the end of 1945, \$2.1 billion of a total of \$4.5 billion of outstanding foreign government dollar bonds were in default. The drawn out adjustment of Latin American defaults arising out of the Great Depression ended in 1958, when Bolivia negotiated a revised payments schedule to clear the last bond default in the Western Hemisphere. By the end of 1962, all countries outside of the Sino-Soviet bloc--except the Republic of Congo--had settled their defaulted dollar bonds by resuming full or adjusted debt service.

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Readjustment of International Debt: Case Studies

Once a country defaulted on its debt, the terms of the loan had to be readjusted. The US settlements of defaulted debt in Latin America and Europe resembled those involving British and other foreign creditors.

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Latin American Dollar Bonds

The US government played an insignificant role in the adjustment of defaulted Latin American obligations held by US citizens. In 1933, President Roosevelt proclaimed a policy of non-interference in private debt situations as part of the country's Good Neighbor policy. In accordance with this policy, default settlements were negotiated strictly between US bondholders and foreign borrowers. The State Department largely limited its involvement to protesting foreign government

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repayment plans that treated US bondholders less favorably than other foreign creditors. Diplomatic intervention sometimes won better treatment for US bondholders but was used infrequently.

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Private bondholders held no effective legal recourse over defaulting foreigners. Official borrowers could not be sued in their own courts without their consent. Even if US bondholders could obtain a favorable judgment in the courts of a defaulting government, enforcement was improbable. While foreign private defaulters did not enjoy these general immunities from lawsuits, legal action rarely proved effective. Although foreign private bonds issued in the United States fell under US jurisdiction, plaintiffs were compensated only in the few instances when foreign debtors held attachable assets in the United States.

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Left without official or legal redress, private bondholders attempted to negotiate directly with defaulting foreigners. Through the early 1930s, investment banks and third-party private negotiators independently organized about 40 special committees, each concerned with readjusting the terms of particular foreign bond issues in default. The decentralized system of special committees failed to represent bondholders effectively, however, because the committees often lacked credibility with foreign governments. They often worked against one another in separately securing settlements. The committees also were criticized for allegedly profiting from fraudulent settlements.

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Bondholders, negotiating from a position of weakness, accepted various debt readjustment plans essentially dictated by

the defaulting foreign governments. The borrowers offered bondholders about 25 temporary settlements during the early 1930s designed to relieve their debt service burden during the depression without defaulting and thereby foreclosing future access to private bondmarkets. Settlement plans were short term, covering 1-5 years. Most plans completely suspended amortization payments during the contracted period, although certain arrangements allowed the issuer to cancel his bond through repurchase. Interest payments in scarce dollars were reduced over the life of the arrangement; they were either written-off or paid (in part) with new funding obligations² or nonconvertible foreign currencies. [REDACTED]

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The failure of the system of special committees to represent bondholders adequately prompted Washington to act. The US government in 1933 requested the formation of a private organization--the Foreign Bondholders Protective Council, Inc.--to represent all private bondholders in negotiations with defaulting foreign governments. Almost all readjustment plans subsequently were negotiated under the auspices of the Council.

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[REDACTED]

The Council successfully represented bondholders in 34 negotiated settlements between 1933 and 1958 involving

² Script and funding bonds were issued. Script bonds were short-term obligations which could bear interest. Funding bonds were long-term securities which bore interest. Although holders could cash these bonds for dollars on the secondary market, the obligations usually exchanged hands at substantial discount from face value. [REDACTED]

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22 countries, 13 of which were Latin American. Once negotiated and recommended by the Council, the settlements were broadly accepted by private bondholders.³ The Council oversaw the resumption of servicing on \$3.4 billion of formerly defaulted bonds. Defaults on the revised terms of the Council's settlements proved rare. [REDACTED]

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Settlements recommended by the Council shared several general characteristics. Debt relief primarily took the form of interest rate reductions, ranging from 10 to 70 percent of the nominal rate, and maturity extensions. Most approved settlements stipulated partial payment on arrears of interest, usually in the form of additional bonds. At no time did the Council recommend any plan that prevented the bondholder from potentially regaining full repayment of his initial investment. [REDACTED]

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The permanent settlement of Brazil's defaulted bonds was typical of the Council-sponsored agreements with many Latin American countries, including Chile, Colombia, Cuba, El Salvador and Peru. After making partial interest payments between 1934 and 1941 under a series of temporary adjustment plans, Brazil negotiated an approved Council settlement, known as the Souza Plan, which took effect in 1944. The plan offered bondholders two options. The first option maintained the face value of the bonds but cut interest rates by two-thirds and extended the

³ Individual bondholders occasionally exercised their right to reject the Council's recommendations in hopes of securing better settlements later. Some bondholders also accepted readjustments rejected by the Council rather than risk no settlement at all. [REDACTED]

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amortization schedule by 1.5 to 10 times the original period. The second option cancelled 20-50 percent of the principal, halved interest rates, and extended maturities by less than the first plan. Under the Souza Plan, Brazil cut its aggregate debt servicing obligation by about 75 percent. Full debt service on the reduced debt was subsequently resumed, and all the dollar issues were retired in 1968. [REDACTED]

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At least one Latin American country readjusted defaulted bonds under terms deemed unacceptable by the Council. The longstanding International Committee of Bankers on Mexico negotiated its own agreements with Mexico in 1942 and 1946 which cancelled 80 percent of principal and over 99 percent of interest arrears. The 1946 agreement also provided for the retirement of bonds at prices as low as 21 percent of their face value. Most bondholders accepted these drastic debt write-offs as the best settlement possible, and Mexico subsequently redeemed the adjusted bonds in 1960. [REDACTED]

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Although negotiated settlements brought a great reduction in defaulted dollar debt, a still larger decrease occurred through unilateral action by various debtor states. Foreign governments effectively cancelled many of their defaulted bonds by repurchasing them from US bondholders in the secondary market at discounted prices as low as 10 percent of face value. Official debtors also eliminated many defaulted dollar bonds held by their nationals through costly, enforced settlements. Some of these bonds were repudiated outright, while others were repurchased with less desirable local currency. Foreign governments also

converted many of their locally held defaulted dollar bonds into domestic obligations payable in local currency in order to economize on scarce dollars.

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German Reparations

Unlike Latin America, Germany had to generate income to service its external debt with an economy devastated by war. The settlement of Germany's war reparations consequently was complicated and dominated Western financial relations between the wars. The Allies undertook three programs over ten years to facilitate war compensation payments: the London Settlement, the Dawes Plan, and the Young Plan.

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The London Settlement remained formally in operation from May 1921 to September 1924. The Plan specified annual instalments to repay about 50 billion marks, carrying 6 percent interest, of the 132 billion mark (\$33 billion) liability established by the Allies as full compensation for war damages.⁴ Payments consisted of a fixed sum of 2 billion marks and a variable sum equivalent to 26 percent of the value of Germany's yearly exports. Payments were to be in cash and in kind, with the initial fixed payments payable in cash. The Allies expected that the variable payments schedule, conditioned on export performance, would ensure proper debt servicing by

⁴ The repayment schedule for the remaining 82 billion marks of reparations was not drawn up because credits for past German payments and the contributions owed by other Central Powers had not been determined.

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Germany.

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Germany encountered payments difficulties immediately, however, and defaulted within 15 months. War obligations exceeded the nonborrowed revenues of the government during 1922-23, resulting in large deficit spending that was financed by inflationary currency issue. Inflation and the vigorous efforts of the government to purchase foreign exchange for reparations payments stimulated a rapid mark depreciation. The currency depreciation increased Germany's reparations obligations in terms of marks, encouraging further monetary expansion and inflation. Payments shrank and Germany--experiencing severe economic problems including hyperinflation--was declared in default in January 1923 after having made cash payments totaling only 1.7 billion marks during 1921-22.

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Germany's failure to meet its payments under the London Settlement inspired the design of the next program, the Dawes Plan. Allied reparations policy turned from effecting full compensation at any cost to ensuring a feasible repayment plan by rehabilitating the German economy. The Dawes Plan was conceived as a temporary arrangement by its authors until Germany developed the capacity to shoulder a comprehensive settlement.

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The Dawes Plan reduced Germany's short-term reparations obligations to give Germany time to increase the country's capacity to pay. Political considerations prevented any reduction in Germany's total liability, but annual payments--payable in cash and in kind--were reduced significantly through a repayment schedule running for an indefinite term. The annual

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obligation for the first year was 1 billion marks, 80 percent of which was financed by an international bond issue sponsored under the Dawes Plan. The annual instalments rose steadily through the fifth year when they leveled off at 2.5 billion marks.

Thereafter, the annuity became variable, adjusted if price fluctuations of gold exceeded 10 percent or if the German economy prospered.

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The payment mechanism included safeguards to protect the stability of the German financial system. Germany's cash obligations to the Allies were denominated in marks and therefore were not subject to default when foreign exchange was unavailable. The Allies, in turn, agreed not to convert marks to their currencies if the mark's value were threatened.

Reparations payments to the Allies subsequently could be waived if too many marks accumulated in Allied hands. Mark annuities could also be suspended if German government revenues declined appreciably.

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The Dawes Plan proved successful over its five-year lifespan but only because Germany borrowed heavily abroad. All annuities due--totaling 7.6 billion marks--were paid promptly and in full. Domestic economic prosperity returned to Germany, and the currency regained stability. These successes, however, were underpinned by a massive buildup of foreign debt. Germany borrowed over 14 billion marks abroad--much of it in the form of short-term bank credits--to finance economic recovery. These credits, unlike the reparations obligations, could be serviced only with foreign exchange. Export earnings during these years,

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however, barely returned to prewar levels, far short of the amount needed to finance debt payments and domestic economic recovery. Germany, in effect, borrowed from foreigners to pay their reparations, avoiding compression of domestic living standards as long as capital inflows continued.

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Germany and the Allies sought to implement a definitive reparations settlement in 1929, encouraged by the ongoing economic recovery in Germany and the industrialized world. The Young Plan reduced Germany's liability to 121 billion marks⁵ (\$29 billion), payable over 59 years. Annuities were set on a slowly rising scale beginning at two-thirds of the fifth-year annual payment under the Dawes Plan and averaging four-fifths of that amount. Fixed payments replaced variable instalments; the gold price and prosperity adjustments specified by the Dawes Plan were suspended, along with the provision to safeguard the currency. The Young Plan also sponsored a \$300 million bond issue to help finance the annuities.

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The onset of the Great Depression buried the Young Plan within two years and, with it, German reparations. Germany quickly was engulfed in financial chaos, suffering declining exports, the cutoff of credit, and capital flight. Germany made payments on only three annuities, ending service with the Hoover Moratorium in 1931. Germany is estimated to have paid only \$5-\$9 billion on its \$33 billion reparations bill.

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⁵ Including interest obligations.

Allied War Debts to the US

The difficulties Germany experienced in paying reparations to the Allies complicated the Allies' effort to repay war loans to the United States. The United States agreed to readjust Allied war debt because it recognized that economic conditions after the war were not conducive to servicing over \$10 billion worth of debt, almost all of which was due during the early 1920s. The settlement of US war loans with 13 European countries took place between 1923 and 1926.

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Although terms varied widely, the readjustment of Allied debt significantly reduced annual servicing requirements by extending repayment periods. Short-term credits were consolidated and converted into bonds maturing in 62 years. No principal was cancelled, and interest arrearages were partially reduced before being incorporated as funded principal. Additional debt relief instead was provided by interest rates fixed at reduced levels. Provisions also were included for postponement of servicing under certain conditions. Total debt consequently was cut approximately in half--to about \$6 billion--for the 13 European debtors as a group, with reductions ranging from 19 percent (Finland) to 75 percent (Italy) to reflect the debtors' differing capacities to repay. The instalments of principal and interest were payable in gold or in US bonds.

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Significant debt relief failed to prevent Allied default, however, during the Great Depression. The Allies confronted the same problems encountered by Germany, including balance of payments problems and the absence of external credit, and they

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too halted payments with the Hoover Moratorium. Only Finland resumed full debt service after the Moratorium. To date, the US has received only \$2.8 billion in principal and interest on growing obligations that now probably exceed an estimated \$30 billion.

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Lessons Learned

Debt readjustment policies adopted early this century resemble current restructuring arrangements for lesser developed countries. Creditors sought to assist debt-troubled countries by lowering the level of annual debt obligations and maintaining debt service in the face of adverse external shocks. Debt relief was provided by various combinations of interest rate reductions, maturity extension, refunding, cash substitution, and sometimes principal reduction.

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The interwar experience in debt readjustment, however, cannot guide action in current rescheduling exercises. The relative merits of particular debt strategies crucially depend on the nature of the debt involved. The war debt derived from the destruction of productive capacity in Germany and the Allied countries, undercutting Europe's capacity to service debt for many years; under this unique circumstance, drastic cancellation of principal and token repayments probably were appropriate. The default settlements adopted for interwar Latin America debt also are inapplicable today because of the differences between bonds and bank loans, the predominant form of debt currently owed by Latin America. Banks today cannot liquidate their Latin

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portfolios as bondholders did earlier without possibly endangering the international financial system.

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Broad lessons, however, can be learned from the settlement of interwar debts. Although interwar debt relief techniques reduced hard-currency debt service obligations in the short run, debt repayments continued to represent a steady burden on the budget and balance of payments of debtor countries. Even readjustments that incorporated flexibility clauses--for example, the conditional annuities on export performance and on domestic and international conditions included in Germany's various readjustment programs--failed to prevent default when economic conditions deteriorated as they did in the early 1920s. While the provision for flexibility afforded some protection to debtors, it tended to lower the credit standing of the debtor country in the view of investors, whose repayment prospects were much less certain. Foreign financial support consequently was quick to disappear when economic conditions worsened.

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The historical record of international debt readjustment confirms that restructuring schemes can help resume stalled debt servicing but cannot insure debt repayment over the long run. In the final analysis, debt servicing depends not on the effectiveness of restructuring techniques but rather on the ability of debtors to earn the foreign exchange of creditors through trade. Other means of acquiring foreign exchange cannot finance debt repayment on a sustained basis: accepting foreign loans only increases the amount of debt owed; liquidating portfolios of foreign securities is a limited option and

eliminates a source of foreign exchange in the form of future interest income; and purchasing with domestic currency ultimately debases the currency's value until foreigners refuse to accept it. Debtors, therefore, must export more than they import to repay debt. If their debt must be repaid with their creditor's currency, however, the creditor must be willing to run a trade deficit with the world; otherwise, the necessary foreign exchange will not be available to the debtor at a feasible exchange rate to fund his debt repayment.

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Although the debt relief afforded Germany and other European countries was significant, debt readjustment policies alone failed to resolve debt problems because they did not insure creditor cooperation--i.e., creditors were allowed to pursue policies that hindered debtors from servicing debt. Allied war debts to the United States were halved and German reparations annuities were scaled down appreciably. At the same time, however, creditors restricted debtor exports to creditor and third-country markets. The United States, in particular, increased import tariffs in 1922 and 1930 to restrict European access to domestic markets. Private foreign lending masked for a decade the debtors' inability to earn foreign exchange through trade. The lending cutoff after 1928 left debtors to repay with their own resources, exposing the flaw of the readjustment policies.

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Latin American debt defaults were resolved because export opportunities accompanied the standard readjustment techniques. World War II greatly increased the demand of the US and Great

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Britain for raw materials from Latin America. The war also enabled Latin America to broaden its export base through encouragement of agricultural diversification and increased industrialization. As a result, Latin America was able to replenish its reserves of foreign exchange and gold and to finance the resumption of debt servicing and the repurchase of much of the defaulted debt. Without its strong export position, Latin America probably could not have settled its defaulted debt merely on the basis of negotiated debt relief.

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SUBJECT: Lessons Learned from the Pre-World WarII Debt Crises

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